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ABSTRACT

Looking for ways to save money within the Stafford Student Loan program, a study was done to measure the effect that a lower special allowance could have on the supply of Stafford loans made with private capital. The special allowance is an incentive payment to commercial lenders who participate in guaranteed student loan programs. The study used a multiple regression analysis that focused on the relationship between commercial lenders' rates of return and the supply of Stafford loans they financed. This allowed the study to predict the commercial supply of Stafford loans that corresponds to lower special allowances. Results of the study indicated that a lower special allowance should cause little change in commercial lending, that such a reduction would mean significant program savings, and would result in more loans by fewer lenders. This could be done while not adversely affecting the Stafford loan program's reliance on loan capital supplied from the private market, attenuating students' access to subsidized loans, or discouraging most lenders from participating. It was estimated that a special allowance reduction to 3 percent would result in about a 1 percent decrease in projected commercial loan volume. Appendixes contain details of the statistical methodology and regression models. (JB)

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United States General Accounting Office

GAO

Report to Congressional Committees

January 1992

STAFFORD STUDENT LOANS

Lower Subsidy Payments Could Achieve Savings Without Affecting Access

HE025 236

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United States
General Accounting Office
Washington, D.C. 20548

Human Resources Division

B-246534

January 6, 1992

The Honorable Edward M. Kennedy
Chairman, Committee on Labor
and Human Resources
United States Senate

The Honorable William Ford
Chairman, Committee on Education
and Labor
House of Representatives

Student access to private loan capital has greatly improved since the inception of the guaranteed student loan programs. Initially, commercial lenders made student loans only to borrowers who resided in their state or local jurisdiction. This severely limited students' access to subsidized loans. To remedy this situation, the Congress established the current special allowance formula to attract a large number of financial institutions, thereby making student loans more readily available. Between fiscal years 1977 and 1985, the number of participating lenders increased from about 4,000 to over 11,000.

Since bank deregulation, however, the financial services industry has operated on a more sophisticated level. In particular, commercial banks now make loans across state lines through the use of regional branch-banking networks and bank holding companies. This process has helped transform the guaranteed student loan programs from a regional into a national operation, making the need for the current subsidy rate less clear.[1]

The cost of the Stafford Student Loan Program has come under increased scrutiny by public policymakers. Cost-saving measures recently undertaken by the Congress have focused primarily on shifting costs to student borrowers by raising student loan interest rates, limiting program eligibility, and establishing unsubsidized loan programs. With reauthorization of the Higher Education Act serving as the backdrop, the Congress is exploring alternative ways to cut costs without adversely affecting the program's mission—to assure student accessibility to loan capital. This report focuses on probable program impacts if

[1]Four separate programs now exist: the Stafford, Parent Loans for Undergraduate Students, Supplemental Loans for Students, and Consolidation Loans. The umbrella term for these programs is the Stafford Student Loan Program.

the Congress reduces the federal subsidy paid to commercial lenders who make or hold guaranteed student loans.

Many specialists in educational finance contend that lenders' profits from the subsidy are above the amounts needed to maintain adequate participation in the student loan program. Lowering this subsidy is an attractive option because a small reduction can generate significant savings. Our principal objective was to determine the effect that lower rates of return, as a consequence of reducing the subsidy rate, could have on the volume of Stafford loans supplied by commercial lenders.[2]

Background

Guaranteed student loan programs are the largest single source of federal financial assistance provided to students pursuing postsecondary education. Under present law, a student typically borrows from a commercial bank, which often sells the loan to another bank or financial institution. Each state establishes or designates an agency—called a guaranty agency—to, among other things, guarantee student loans within its jurisdiction. Guaranty agencies insure lenders against defaulted loans, and in turn are reinsured by the Department of Education. Guaranty agencies must also serve as or appoint a lender of last resort.

To insure an adequate stock of private loan capital, the federal government makes incentive payments—the special allowance—to commercial lenders who participate in guaranteed student loan programs. The special allowance is a quarterly supplemental interest payment intended to yield lenders a near-market rate of return. Lenders bill the Department of Education quarterly for their special allowance payments for the life of the loan. At $1.7 billion, special allowance payments accounted for about one-third of the guaranteed student loan programs' costs in fiscal year 1989.

The Department has used a legislatively set formula tied to government securities to calculate special allowance payments since fiscal year 1977. Two components comprise the formula. The first component is set equal to the bond equivalent yield on 91-day Treasury bills. The second component is an additional interest supplement—the special allowance factor—of 3.25 percent. If the borrower's interest rate is below this guaranteed yield, the Department pays lenders the difference.

[2]Stafford loans comprised about 78 percent of guaranteed student loans made in fiscal year 1989.

The Congress has adjusted the special allowance payment formula in the past. The most recent adjustments occurred in 1986, starting with the Gramm-Rudman-Hollings budget sequester (Public Law 99-177). The sequester temporarily reduced the special allowance factor from 3.5 to 3.1 percent for new loans made between March 1 and September 30, 1986. The reduction applied to the first four quarterly subsidy payments for each loan made during that period. Subsequently, the Higher Education Amendments of 1986 reduced the special allowance factor from 3.5 percent--a factor that had prevailed since fiscal year 1977—to 3.25 percent for most new loans made after November 15, 1986.

Results in Brief

The rate of return most commercial lenders receive on Stafford loans is probably higher than the return necessary to retain them in the program. As such, moderate reductions to the special allowance could generate substantial savings without jeopardizing the program's reliance on private loan capital. A special allowance factor of 3 percent could generate cumulative savings of about $421 million between fiscal years 1992 and 1996—a present value of $344 million. This could, in turn, cause the cumulative loan volume from commercial lenders to decline by about 1 percent over the same period if loan supply remains insensitive to changes in the relative rate of return.

Guaranty agencies will continue to bridge the difference between student loan demand and loan capital supplied by commercial lenders through their direct loan programs. Historically, guaranty agencies have made between 1 and 7 percent of Stafford loan volume annually—adjusted for inflation. Guaranty agency lending accounted for about 3 percent of Stafford loans in fiscal year 1989. The guaranty agency lending necessary to offset the drop in commercial loans caused by a moderate reduction in the special allowance factor is well within their demonstrated lending capacity.

A reduction in the special allowance could increase the student loan market share controlled by large-scale commercial lenders.[3] High-volume lenders have rarely left the program or curtailed their participation level. Therefore, a drop in future commercial loan supply caused by lowering the special allowance is likely to result from a few small-volume lenders leaving the program rather than a proportionate decrease by all

[3]Traditionally, a small proportion of lenders with high loan volumes make a substantial portion of all loans. For example, in fiscal year 1989 the 100 largest originating lenders comprised only about 1 percent of all program lenders but disbursed 60 percent of the dollar value of all Stafford loans.

lenders. To capitalize on economies of scale, high-volume commercial lenders may absorb some of the student loan market abandoned by these small lenders.

Scope and Methodology

We used multiple regression analysis—a standard statistical method—to measure the effect that a lower special allowance could have on the supply of Stafford loans made with private capital. Our statistical analysis focused on the relationship between commercial lenders' rates of return and the supply of Stafford loans they financed. This allowed us to predict the commercial supply of Stafford loans that corresponds to lower special allowances. Appendix I provides further details on our statistical methodology.

To supplement our statistical analysis, we also

- analyzed the lending activities of guaranty agencies to determine their capacity to continue financing Stafford loans with public funds,
- surveyed a judgmental sample of commercial lenders to determine the relative role profitability played in their student loan lending practices, and
- examined trends in commercial lender participation to determine if it changed since the latest revisions to the special allowance.

We obtained information from the guaranty agencies on the volume of Stafford loans they originated. As a safety-net feature, the student loan program relies on these institutions to safeguard student access to subsidized loans by supplementing private loan capital with public funds. As lenders of last resort, the law requires guaranty agencies to make loans to students who qualify for Stafford loans but are unable to obtain them from a commercial lender.

Large scale lenders dominate the student loan market and, as such, are vital constituents of guaranteed student loan programs. Therefore, we collected information on commercial lenders who originated a high volume of Stafford loans. First, we ranked commercial lenders in descending order based on loan volume for each fiscal year, 1977 through 1986. Second, we traced the lending activity of the lenders who accounted for at least 60 percent of Stafford loan volume for each fiscal year, 1977 through 1989. Third, we interviewed representatives from the 1977 lender cohorts who had either stopped, significantly reduced,

or recently started their participation. The respondents gave us information regarding the extent to which changes in student loan profits influenced their present lending practices.

We also analyzed the trends in the number of commercial lenders who have actively participated in the Stafford loan program. Under our definition, an active lender is one who made at least one Stafford loan during the fiscal year. This allowed us to quantify changes in lender participation rates and levels that have occurred since the last adjustment to the special allowance.

We performed our work between August 1990 and May 1991 in accordance with generally accepted government auditing standards.

GAO's Analysis

A Lower Special Allowance Should Cause Little Change in Commercial Lending

The commercial supply of Stafford loans has changed very little in response to fluctuations in the relative yield on student loans.[4] This suggests that the rate of return to Stafford lenders is higher than what is necessary to maintain their interest in the program. For example, the 1986 reductions in the special allowance factor had no observable effect on lender participation in the Stafford program. The financial return on Stafford loans is high relative to comparable investments, so that other factors likely govern the program's supply of private loan capital. Therefore, we expect that a minor reduction in the special allowance factor would have a negligible effect on the commercial supply of Stafford loans.

To demonstrate the effect that lower special allowance factors could have on the commercial supply of Stafford loans, we generated a 5-year forecast of loan volume, assuming three different special allowance factors. The baseline forecast used the current factor of 3.25 percent. Our other two projections used special allowance factors of 3.0 and 2.75 percent, respectively. Figure 1 displays the results, expressed in 1982 dollars.

[4]The relative yield is the difference between the return on Stafford loans and the yield on 10-year Treasury notes.

Figure 1: Projected Commercial Loan Supply (1992-96)

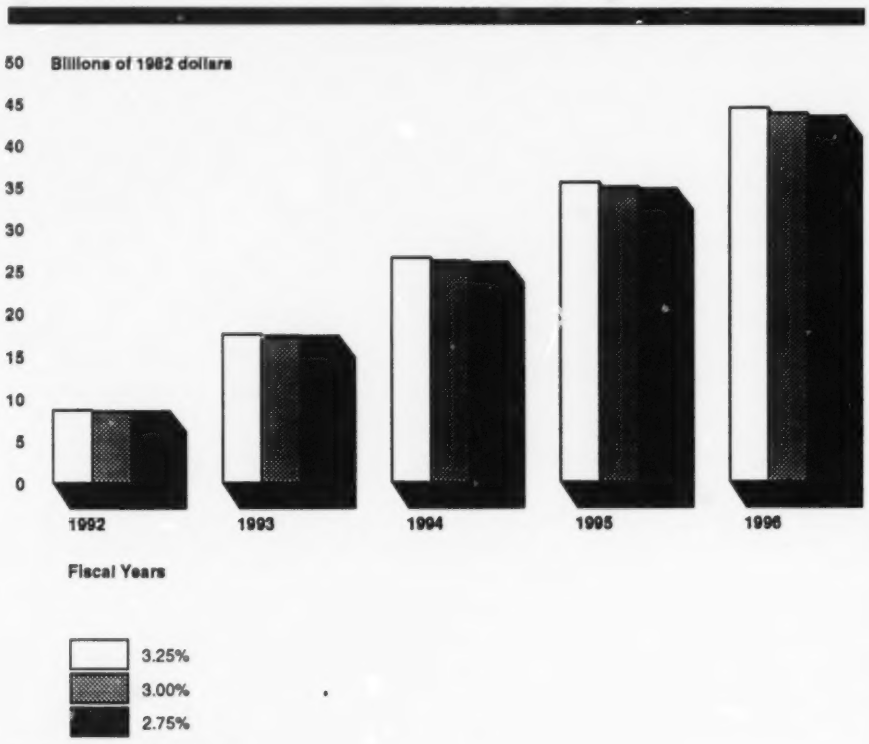


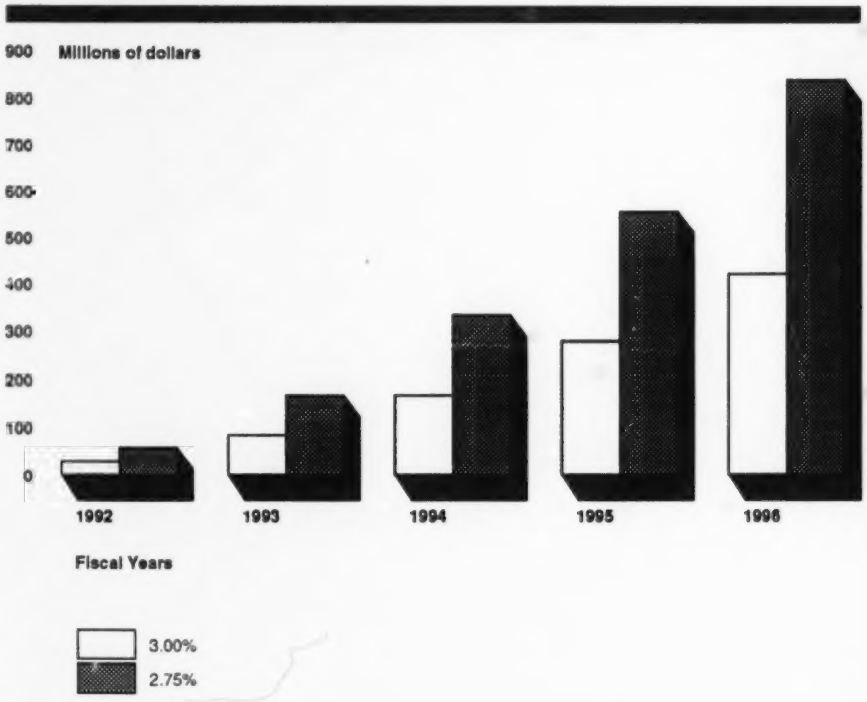
Figure 1 shows that future commercial loan supply is similar under all three scenarios. The disparity in the three forecasts results from different rates of growth. Under the baseline forecast, cumulative loan volume would reach about $44.2 billion for the 5 years ending in fiscal year 1996—an average annual growth rate of 1.7 percent. For the same period, under different allowance factors, the results would be as follows.

- 3.0 percent: cumulative loan volume would reach about $43.7 billion—an average annual growth rate of 1.4 percent—or about 1 percent lower than the baseline forecast.
- 2.75 percent: cumulative loan volume would reach about $43.2 billion—an average annual growth rate of 1.2 percent—or about 2 percent lower than the baseline forecast.

A Smaller Special Allowance Means Significant Program Savings

Substantial program savings could accompany a moderate reduction in the special allowance factor. The savings are affected by lower subsidy rates rather than a lower quantity of loans. Figure 2 shows cumulative savings through 1996 if the special allowance factor is reduced to either 3.0 or 2.75 percent. This analysis assumes that the lower special allowance formula takes effect at the beginning of fiscal year 1992. Because guaranty agency lending would make up the difference between student loan demand and loans supplied by commercial lenders, our savings estimates do not reflect a decline in the overall supply of Stafford loans.

Figure 2: Potential Cumulative Savings Under Lower Special Allowance Factors (1992-96)



Because the lower subsidy factors would only affect new loans, the savings would be realized gradually over time. As the number of student loans subject to the reduced special allowance factor increases, the new rate would have a greater effect on program savings. After 5 years, the total savings associated with reducing the special allowance factor would be as follows.

- At 3.0 percent, savings would be about $421 million—a present value of $344 million.
- At 2.75 percent, savings would be about $838 million—a present value of $685 million.

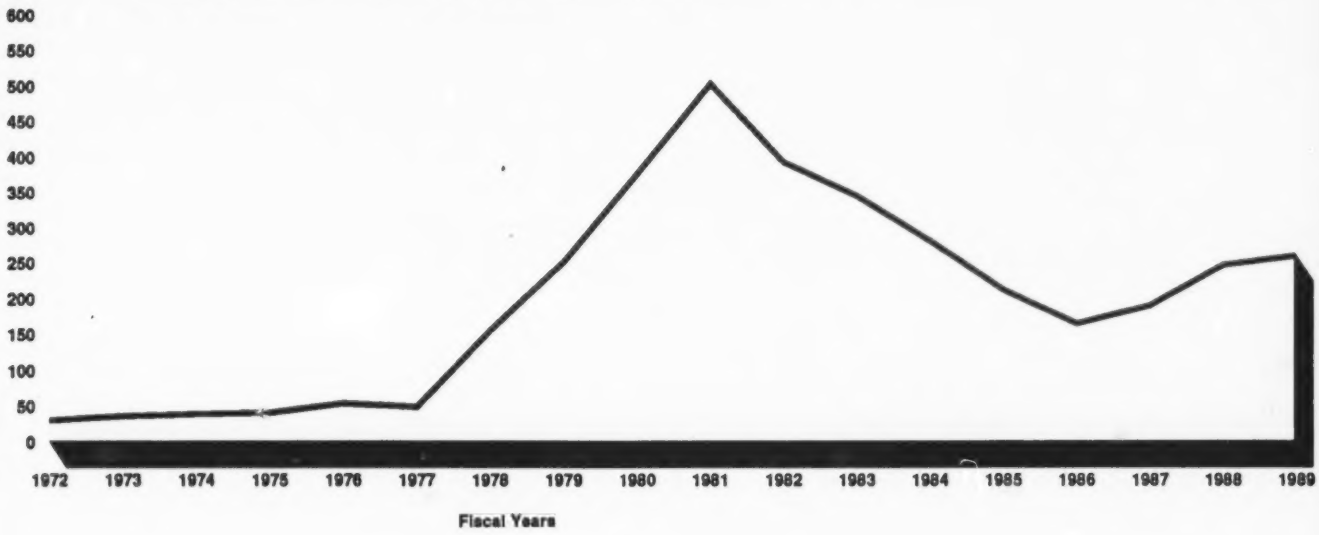
Guaranty Agencies Would Continue to Ensure Access

Guaranty agencies can readily fill the gap between student loan demand and commercial loan supply caused by a moderate reduction in the special allowance factor. In comparison to their historical lending activity, guaranty agencies' current Stafford loan volume is relatively small. Moreover, a recent surge in guaranty agency lending is attributable to some of the agencies voluntarily deciding to finance Stafford loans to students who are ineligible for the federal in-school interest subsidy. This suggests that—in terms of making loans to qualifying students—the guaranty agency lending structure has the capacity to accommodate additional demand.[5]

Figure 3 illustrates how guaranty agencies' Stafford loan volume has changed over time.

[5]Although the law obligates guaranty agencies to offset private loan capital shortfalls, we believe—for the ranges we specify—the agency lending induced by a moderate reduction in the special allowance factor is (1) an appropriate supplemental measure and (2) consistent with using direct loan programs as a safety net for student borrowers.

Figure 3: Guaranty Agency Stafford Lending by Dollar Volume (1972-89)



Source: Department of Education.

Guaranty agency lending peaked at $502 million in fiscal year 1981, adjusted for inflation. This peak had declined to $259 million—a 48-percent reduction—by fiscal year 1989. As a percentage of dollar volume, guaranty agency lending peaked at 7.4 percent in fiscal year 1979. Guaranty agencies accounted for about 3 percent of Stafford loans originated in fiscal year 1989.

Legislative changes and program maturity explain the most notable patterns in guaranty agency lending that occurred between fiscal years 1977 and 1981, and fiscal years 1986 and 1989. Between 1977 and 1981, the volume of Stafford loans made by guaranty agencies increased almost 1,000 percent—from $48 to $502 million. This coincided with the implementation of the Middle Income Assistance Act of 1978, which greatly expanded the pool of eligible students but preceded the widespread private sector participation exhibited today.

Beginning in 1981, guaranty agencies' Stafford loan volume declined for 5 consecutive fiscal years. Initially, this was due in part to a needs test that required Stafford loan applicants with incomes greater than

$30,000 to show need to qualify for federally subsidized loans. Consequently, the pool of eligible applicants contracted. Moreover, as the program's popularity grew with lenders, the need for guaranty agencies to make loans diminished. Between fiscal years 1977 and 1981, the number of commercial lenders and their volume of loan originations grew by about 90 percent and 685 percent, respectively.

Changes mandated by the Higher Education Amendments of 1986 appear largely responsible for the recent growth in guaranty agency lending. This legislation requires, among other things, that all Stafford loan applicants show need in order to qualify for a federally subsidized loan. In an attempt to "re-enfranchise" the middle class, some guaranty agencies began making Stafford loans to students displaced by the needs test.[6] As a result of these special loan programs, guaranty agency lending increased by almost 80 percent between fiscal years 1986 and 1989.

High-Volume Lenders Seldom Leave the Program

High-volume commercial lenders—those most crucial to the program's success—rarely leave the Stafford loan program. We defined the largest lenders as those included in the cohort that accounted for at least 60 percent of Stafford loan originations in fiscal years 1977 through 1986. We measured program retention by determining what proportion of these lenders continuously participated through fiscal year 1989. The retention rates for the lender cohorts ranged from 98 to 100 percent.

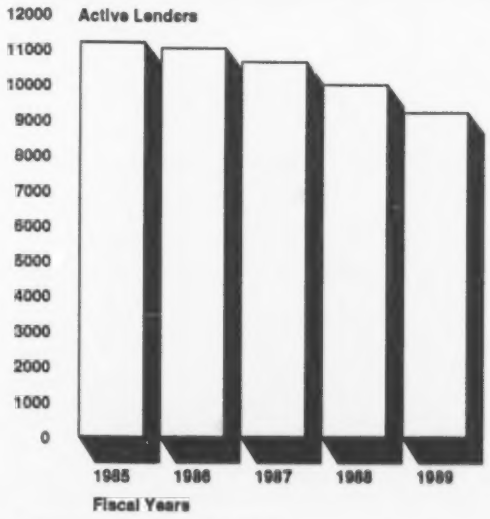
Our survey indicated that high-volume lenders discontinue or curtail their participation generally for reasons other than dissatisfaction with student loan profits. For illustrative purposes, consider the cohort of commercial lenders in fiscal year 1977. The top 160 lenders accounted for about 62 percent of all Stafford loans made in that year. We found that 156—about 98 percent—made Stafford loans in 1989. Only 2 of the 4 lenders who no longer originate loans stopped because of their dissatisfaction with student loan profits.

[6]Although these loans are guaranteed against default, guaranty agencies usually do not receive special allowance payments for them.

A Lower Special Allowance Could Result in More Loans by Fewer Lenders

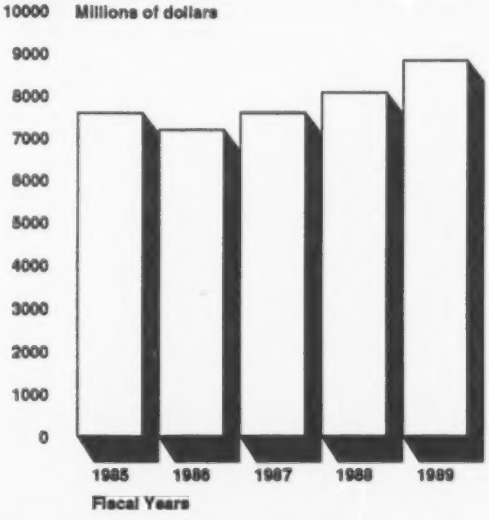
A reduction in the special allowance factor could accelerate the trend toward reducing the number of participating lenders and concentrating the student loan market among large-scale lenders. Since the 1986 revisions to the subsidy, Stafford loan volume from commercial lenders has risen in spite of a decline in the number of active lenders. Figures 4 and 5 show the trend in commercial lender participation between fiscal years 1985 and 1989.

Figure 4: Active Lenders, in Thousands (1985-89)



Source: Department of Education

Figure 5: Amount of Stafford Loans Made by Commercial Lenders (1985-89)



Source: Department of Education.

Before fiscal year 1985, the number of commercial lenders who made Stafford loans had increased each year since the program's inception. The number of lenders has declined slightly each year since 1985, from 11,179 to 9,207 or about 18 percent by fiscal year 1989. During this same period, however, the dollar value of Stafford loans made by commercial lenders increased about 16 percent, from $7.6 to $8.8 billion.

During this same period, the proportion of commercial lenders who made the largest share of Stafford loans had also declined. The largest 230 commercial lenders accounted for 60 percent of Stafford loans made in fiscal year 1985. By fiscal year 1989, the largest 100 lenders accounted for the same percentage of Stafford loans.

Because commercial lenders with high volumes rarely leave the program, the subsidy reductions probably forced some marginal lenders to leave. This kind of "market shakeout" is common among industries, such as student loan operations, that exhibit economies of scale.[7] In the student loan market, some low-volume lenders who were unable to take advantage of economies of scale in their operations discontinued their

[7]Economies of scale exist when lower unit costs are achieved by expanding the scale of operation—increasing output. In such situations, smaller scale operations tend to be inefficient; that is, their average total costs are greater than in a larger scale enterprise.

student loan business. It is likely that larger, more efficient lenders absorbed these vacated market shares. We believe that another reduction in the special allowance would add momentum to this trend.

Limitations of Our Statistical Analysis

Our forecasts of commercial loan supply expected under lower special allowance factors should be viewed with caution. The forecasts are predicated on the relationship between loan supply and the relative rate of return on Stafford loans described by the regression equation. A regression model's scope is restricted ordinarily to the interval of values observed during the analysis period, in this case the range of changes in relative returns received by lenders between 1973 and 1989. The linear regression model appears appropriate for estimating the change in loan supply associated with reductions to the special allowance that fall within this range. In particular, we believe that it adequately supports our recommendation for a reduction of the special allowance to 3.0 percent. Using the regression results to estimate the effect of a reduction that falls far outside the observed range would be hazardous because we cannot be sure that the regression equation that fits the past data is appropriate over a wider range of values.

Conclusion

A modest reduction to the special allowance factor could help reduce the costs of guaranteed student loan programs to the federal government, yet still provide enough incentive to ensure adequate levels of commercial lender participation. A lower special allowance factor would achieve substantial program savings without (1) adversely affecting the Stafford loan program's reliance on loan capital supplied from the private market, (2) attenuating students' access to subsidized loans, or (3) discouraging the segment of commercial lenders most vital to the program from participating. We estimate that reducing the special allowance factor to 3 percent would result in about a 1-percent decrease in projected commercial loan volume. Any reduction in participation by lenders is likely to be balanced at least in part by increased volume from high-volume lenders.

Recommendation

We recommend that the Congress lower the special allowance factor to 3 percent.

Agency Comments

The Department of Education, the Student Loan Marketing Association (Sallie Mae), and two national trade and professional associations for

commercial banks—the Consumer Bankers Association, and the American Bankers Association—provided written comments on a draft of this report. While the Department generally agreed with our findings and recommendation, it suggested undertaking concurrent legislative measures to reinforce the financial condition of guaranty agencies. Sallie Mae and the two trade associations, citing inadequate profits for lenders, recent declines in lender participation, and guaranty agencies' inability to fill the ensuing gap between Stafford loan demand and supply, expressed misgivings about our conclusions and recommendation. Appendix III contains our evaluation of their comments.

We are sending copies of this report to the Secretary of Education, other congressional committees, and other interested parties. This report was prepared under the direction of Franklin Frazier, Director, Education and Employment Issues, who can be reached on (202) 275-1793. Other major contributors are listed in appendix V.

Lawrence H. Thompson

Lawrence H. Thompson
Assistant Comptroller General

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Abbreviations

ABA	American Bankers Association
CBA	Consumer Bankers Association

Appendix I

Statistical Methodology

We used multiple regression analysis to quantify the impact of lower special allowance factors on the commercial supply of Stafford loans. Our task involved estimating a commercial supply curve for Stafford loans.[1] With regression analysis we estimated the commercial loan volume associated with changes in the difference between the return on student loans and the yield on Treasury bonds, while controlling for the effects of other supply-related variables. With the results of this statistical technique, we predicted the volume of Stafford loans that corresponded to lower special allowance factors.

Before specifying the final regression equation, we conducted diagnostic tests to identify possible violations of the assumptions underlying the general linear model. The results indicated cointegration between the natural logarithms of commercial loan volume and activities of the Student Loan Marketing Association (Sallie Mae). Therefore, our analysis consisted of a two-step estimation procedure: a long-run model and an error-correction model that captured the short-run dynamics.

Data Sources

The data used to specify the regression models came from three different sources. The Department of Education supplied the information on total Stafford loan commitments. Guaranty agencies provided data for the years in which they made Stafford loans.[2] Lastly, Sallie Mae provided the information on its loan purchasing and warehousing activities. The database is expressed in 1982 dollars and contains 67 quarterly observations from first quarter 1973 through third quarter 1989. Each independent variable is defined in appendix II.

For our 5-year forecast of Stafford loan volume, the Congressional Budget Office provided us with projections on the unemployment rate, the 91-day Treasury bill (T-bill) rate, and the yield on 10-year Treasury notes.

[1]Because market observations typically entail only equilibrium prices and quantities, separating out demand and supply effects—termed the identification problem—is difficult. However, the identification problem does not exist in the guaranteed student loan market. Student loan demand and commercial loan supply are not equal, and both are observed separately. Throughout the program's history, student loan demand has exceeded commercial loan supply. Guaranty agencies have made up the difference either in their role as lenders of last resort or under specialized loan programs that serve students who fall outside of the program's intended target group.

[2]For our modeling, we defined the volume of commercial lending as the difference between these two sources.

Regression Equation for Long-Run Model

Commercial loan volume—expressed in natural log form—is the long-run model's dependent variable. Table I.1 displays the long-run model's regression coefficient estimates and their associated standard errors. The coefficient estimates show a direct relationship between commercial loan volume and Sallie Mae activities; a 10-percent increase in Sallie Mae activities increases commercial student loan volume by almost 5 percent. This is expected because the Congress created Sallie Mae for the sole purpose of providing capital to commercial lenders so that they can make student loans. Events that provide more lending capital, such as increases in Sallie Mae's activities, would increase commercial student loan volume. Conversely, events that reduce lending capital would reduce commercial loan volume.

Table I.1: Regression Equation for Long-Run Model[a]

Variable	Regression coefficient	Standard error
Sallie Mae warehousing and purchasing	0.4706[b]	0.0534
Constant	−2.6919[b]	0.3152
R^2	0.5370	

[a]The dependent variable is commercial loan volume. Variables are expressed in natural log form.

[b]Significant at 5-percent level of confidence.

Regression Equation for Short-Run Model

Change in commercial loan volume—also expressed in natural log form—is the short-run model's dependent variable. We estimated the short-run model using the error-correction term—calculated from the long-run model—as a regressor. The regressor is the one-period lag of the residual from the long-run model. The sign of this coefficient is negative. When transitory conditions cause loan supply to move above its long-run equilibrium during one period, loan supply will decline in the next period. Table I.2 shows the results of the short-run error-correction model.

Table I.2: Regression Equation for Short-Run Model

Variable	Regression coefficient	Standard error
Change in relative rate of return	−0.0075	0.0149
Lagged change in relative rate of return	0.0453[b]	0.0148
Change in unemployment rate	0.0066	0.0366
Second quarter	0.1533	0.2473
Interaction term—second quarter/trend	0.0282[b]	0.0113
Second quarter interaction term squared	−0.0003[b]	0.0001
Third quarter	1.1645[b]	0.2703
Interaction term—third quarter/trend	0.0256[b]	0.0119
Third quarter interaction term squared	−0.0003[b]	0.0001
Fourth quarter	0.4494[c]	0.2325
Interaction term—fourth quarter/trend	−0.0222[c]	0.0109
Fourth quarter interaction term squared	0.0002[c]	0.0001
Trend	−0.0034	0.0091
Trend squared	0.0001	0.0001
Gramm-Rudman-Hollings	−0.0251	0.0774
Lagged-error correction term	−0.1595[c]	0.0818
Rho	0.1124	0.1646
Constant	−0.5164[b]	0.1894
R^2	0.9790	

[a]The dependent variable is the change in the Natural Log of commercial loan volume.

[b]Significant at 5-percent level of confidence.

[c]Significant at 10-percent level of confidence.

The coefficient estimate associated with the variable of interest—the rate of return—is negative, which is the "wrong" sign. More important, however, the estimate is very small and not statistically significant at any of the conventional confidence levels. This suggests that commercial loan volume is unresponsive to variations in lenders' rate of return within the observed ranges.

On the other hand, the coefficient associated with the one-period lag of rate of return is positive and statistically significant. Although this coefficient is also fairly small, it suggests that lowering the rate of return would have a negative effect on commercial loan supply in the following quarter. Based on this coefficient, a 1-percentage-point cut in the special allowance factor would reduce commercial loan volume by about 4.5 percent.

In specifying our regression models, we may have omitted several variables that could affect student loan volume. However, our analysis of the regression's residuals did not indicate any systematic pattern of exclusion. As specified, the most influential variables are the seasonality terms, lagged change in the rate of return, and the error-correction term.

Variables Used in the Regression Models

Sallie Mae Activities	Serves as a proxy for the secondary market for guaranteed student loans. Secondary market participants purchase loans from originating lenders, thereby providing them money to make new loans. Sallie Mae holds about 50 percent of all guaranteed student loans.
Change in Relative Rate of Return	The one-period change in the difference between the rate of return on Stafford loans and the yield on 10-year Treasury notes. It is an indicator of the return from Stafford loans relative to comparable investment opportunities.
Lagged Change in Relative Rate of Return	Measures the change in the relative rate of return from two periods ago to the previous period.
Change in Unemployment Rate	Measures the change in the unemployment rate from the previous period to the current one. The unemployment rate captures effects on commercial loan volume associated with business cycle fluctuations.
Quarterly Indicators and Interaction Terms	Capture the fluctuations in loan volume that occur seasonally over the course of the year.
Trend/Trend Squared	Capture any tendency of loan volume to exhibit increases or decreases over time that are unexplained by the other variables.
Gramm-Rudman-Hollings	Captures the uncertainty related to the return on student loans caused by the possibility of Gramm-Rudman-Hollings sequestrations.
Lagged-Error Correction Term	Captures the deviations from loan volume predicted by the long- run model, lagged one period.

Agency Comments and Our Evaluation

The Department of Education, the Student Loan Marketing Association (Sallie Mae), and two associations representing commercial banks—the Consumer Bankers Association (CBA) and the American Bankers Association (ABA)—commented on a draft of this report.

The Department of Education

The Department generally concurred with our findings and expressed support for our recommendation, along with some reservations. Notably, the Department suggested that the Congress develop new lender-of-last-resort provisions in conjunction with a reduction to the special allowance factor. While we are not in a position to make such a recommendation, given the critical role of loan assistance, we acknowledge the merit of strengthening the program's safety net. Therefore, we encourage the Department to submit a proposal pursuant to this goal regardless of whether the Congress lowers the special allowance factor.

Sallie Mae, CBA, and ABA

Our evaluation focuses on three prominent concerns identified by Sallie Mae, CBA, and ABA. These include low profitability of student loans, recent declines in lender participation, and guaranty agencies' inability to increase lending activity. These organizations also referred to concerns about lender practices and program conditions that lack major implications to the Stafford program and, therefore, we did not address them.

Low Profitability of Student Loans

All three organizations claimed that Stafford loans are barely profitable. Each cited a recent CBA study that showed the average pretax yield on student loans is 89 basis points, or less than 1 percent, which compares unfavorably to other types of loans.[1] They also asserted that a reduction in the special allowance factor would further reduce the profit level and drive many lenders out of the student loan business. Also, CBA suggested that 10-year Treasury notes are not appropriate for computing the relative profitability of Stafford loans.

Our statistical modeling indicated that changes in commercial loan volume were invariant to changes in the relative rate of return. This suggests that the rate of return on Stafford loans was higher than the return required to maintain the level of commercial loan volume needed to meet student loan demand. Empirical support for this contention was

[1]One hundred basis points equal 1 percentage point.

provided in 1986 when commercial loan volume did not decrease noticeably as a result of the 25-basis-point reduction. Our regression analysis indicates that another small reduction would not materially affect loan volume.

We selected the yield on 10-year Treasury notes to calculate historical relative rates of return on Stafford loans, because this investment instrument entails a comparable risk factor and expected income schedule. Besides using the 10-year Treasury notes, we also compared lenders' relative rates of return from Stafford loans to other investments with similar risk and maturities, such as municipal and state bonds. We found that the gross return from student loans was consistently higher than the return on these investments and, on average, higher than the return on several other comparable investments.

Recent Declines in Lender Participation

Sallie Mae, CBA, and ABA referred to reductions in the number of lenders participating in the student loan program. CBA and Sallie Mae note that lender participation declined 29 percent from 1987 to 1990, with Sallie Mae emphasizing the drop in 1990.

The Stafford program is primarily intended to serve students, and as such, we believe the proper concern is with the commercial student loan volume supplied, not the number of participating lenders. Although throughout the program's history some lenders have withdrawn from the program as loan volume increased, market share has become more concentrated among the largest lenders—those most critical to the program's success. Our review of lender participation data shows that the largest lenders seldom discontinue or curtail their participation. For example, only 2 of the largest 160 commercial Stafford loan lenders in 1977 had withdrawn from the program as of fiscal year 1989.

When we began our review, data on the Stafford program only extended to fiscal year 1989. However, our analysis incorporated the declines in commercial loan volume occurring in fiscal years 1977 (5 percent), 1982 (25 percent), and 1986 (4 percent), which were all of greater magnitude than the approximate 1-percent drop in 1990 reported by Sallie Mae. Including 1990 data would not alter the results reached or the conclusions drawn by our work.

We agree that the Stafford program's 1990 statistics warrant careful review. However, given the relatively minor drop in commercial loan

volume, diagnosing 1990 as the beginning of a long-term condition would be premature.

Guaranty Agencies' Inability to Increase Lending Activity

Sallie Mae, CBA, and ABA expressed doubts that guaranty agencies can make up for the potential drop in commercial loan volume expected to accompany a reduction to the special allowance factor. ABA suggested that lenders will first reduce loans to students attending trade schools, causing guaranty agencies to increase their lending to the highest-risk borrower population. Sallie Mae noted that legal constraints prohibit many guaranty agencies from making direct loans, and that three guaranty agencies performed most of the direct lending undertaken in 1989.

For the ranges specified in the report, we anticipate that only a moderate decline in commercial loan volume would accompany a reduction to the special allowance factor. This leads us to believe that guaranty agencies can bridge the gap between loan demand and commercial loan supply, even if that entails making more loans to riskier students. Guaranty agency costs may rise, because loans to high-risk students might be more expensive to service and collect, but the underlying capacity exists.

The law requires states to serve as the ultimate lender of last resort. Some states that do not allow their guaranty agencies to make direct loans instead funnel public funds through their agencies to third parties, such as nonprofit educational foundations, who administer direct loan programs on their behalf. In other cases, commercial banks perform lender-of-last-resort functions for guaranty agencies. Our report does not account for the lender-of-last-resort activities of commercial banks and thereby may actually understate the historical levels of direct lending. Also, Sallie Mae—at the Secretary of Education's request—can make direct loans to satisfy any student loan demand unmet by commercial institutions and guaranty agencies.

Comments From the Department of Education

UNITED STATES DEPARTMENT OF EDUCATION

OFFICE OF POSTSECONDARY EDUCATION

SEP 10 1991

Franklin Frazier, Director
Education and Employment Issues
Human Resources Division
United States General Accounting Office
Washington, DC 20548

Dear Mr. Frazier:

Thank you for the opportunity to review the GAO Draft Report, "Stafford Student Loans: Lower Subsidy Payments Could Achieve Savings Without Affecting Access," GAO/HRD 91-100, issued July 30, 1991.

All participants in the Stafford Loan Program can, and should make a contribution to reducing costs and improving the effectiveness of that program. The Department also agrees with your conclusion that a moderate reduction in the special allowance, from the present 3.25 percent to either 3 or 2.75 percent could generate significant cost savings in the Stafford Loan Program. Therefore, the Department sees merit in the change you suggest. In our Reauthorization proposal, the Administration has already proposed to reduce the special allowance to 3 percent for lenders with cohort default rates above 20 percent. We would have few problems implementing this reduction in our operations.

We believe that your analysis that a reduction in the special allowance would accelerate the current trend of smaller lenders discontinuing their participation in the Stafford Loan Program is correct. We share your view that this action would further concentrate student loan activity at a few hundred large lenders.

However, a special allowance reduction must be carefully studied before reaching a decision. Your analysis indicates that the 1986 reduction in the special allowance from 3.5 percent to 3.25 percent had no observable effect on lender participation in the Stafford Loan program. A recent Department study, Lender Profitability in the Student Loan Program, also found that current Stafford Loan subsidies provide a high level of profitability. That study found that Stafford Loans are currently more profitable than many other lending activities, and pose substantially less risk than many other types of loans because of the Federal guarantee. However, several recent trends in the Stafford Loan program have emerged which did not exist in 1986 and the 1985-89 period of the Department's study.

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These trends have already had an impact on loan profits and have affected loan access for students. These are:

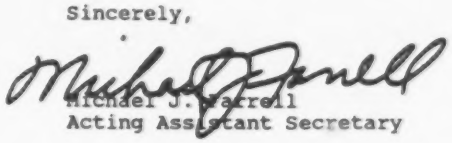
- Guarantee agencies are scrutinizing lenders' default claims more closely, and guarantors have increasingly denied claims because of the lender's failure to comply with due diligence requirements;
- Secondary markets are having trouble arranging financing and this has resulted in less liquidity and driven some lenders from the program; and
- Lenders have begun to restrict lending to students attending trade schools because those loans are less profitable because of their higher operational costs, lower average loan amount, and shorter in-school periods.

The Administration is committed to increasing access to postsecondary education, enhancing choice, and ensuring the financial stability of guarantee agencies. We must be careful that any reduction in special allowance does not interfere with our achievement of these objectives.

Therefore, we assume that while Stafford Loans would continue to be profitable under a reduced special allowance, the combination of a reduced subsidy and higher costs incurred from denied default claims will shift lenders away from making less profitable loans. In turn, this will create a greater demand on guarantee agencies who are required to serve as the Lender of Last Resort. Some guarantee agencies simply could not meet a high demand, and this could negatively affect the financial stability of others. New Lender of Last Resort legislative provisions should be developed in combination with any special allowance reduction to preserve loan access to students and to safeguard the financial stability of guarantee agencies.

Thank you again for this opportunity. If you have any questions, please contact Ernst Becker, Director of the Division of Quality Assurance at 708-5620.

Sincerely,



Michael J. Farrell
Acting Assistant Secretary

Comments from the Student Loan Marketing Association

STUDENT LOAN MARKETING ASSOCIATION
1050 Thomas Jefferson Street, N.W.
Washington, D.C. 20007-3871
202-298-3075

ALBERT L. LORD
Executive Vice President and
Chief Operating Officer

August 26, 1991

Mr. Joseph J. Eglin, Jr.
Assistant Director
U.S. General Accounting Office
Human Resources, Division
GAO Building
441 G Street, N.W.
Washington, DC 20548

Dear Mr. Eglin:

We appreciate the opportunity to comment on the GAO draft report regarding possible changes to the Special Allowance paid on guaranteed student loans. You can be certain we have considered your report carefully. We believe the observations and conclusions to support GAO's recommendation for a 50 basis point reduction in the Special Allowance are seriously flawed.

The central conclusion of the GAO report is that aggregate GSL lending volume will be reduced only minimally by the proposed 50 basis point reduction in lender compensation. Important to this conclusion is your assertion that guarantors, acting as lenders of last resort, will mitigate the loss of commercial lender support.

This letter addresses, in some detail, the key assumptions made in your report. As a general observation, however, we struggle with your concept that commercial banks will continue to participate in this program virtually without compensation (the average after-tax return of the student loan would fall to about 25 basis points). Further, we believe there is substantial wishful thinking involved in the notion that guarantors have the capital and capability to be significant direct lenders.

Current information on the GSLP lending activity by commercial lending institutions and guaranty agencies provide no basis for these conclusions. Sallie Mae is a keen observer of the economics of student lending as well as the behavior of commercial lenders and guarantors. Our view as to the effect of GAO's proposed special allowance reduction is very different than your conclusion. Congressional reliance on the GAO's reported findings would imperil future GSLP access for a significant population of eligible borrowers.

We believe the GAO's prediction of a $1 billion decline in lending attributable to the recommended cuts in the Special Allowance is grossly understated. But even if GAO's conclusion were to be close to correct, we view seriously the significance of that $1 billion decline in loans to students. We do not dismiss so lightly borrowers' loss of access to nearly 400,000 student loans.

Our detailed observations follow:

ASSESSMENT OF COMMERCIAL LENDER COMMITMENT TO GSLP PARTICIPATION

"A lower Special Allowance should cause little change in commercial lending." (GAO Report, p. 7)

Recent trends in commercial lender GSLP participation indicate that such lending is in a critical period. From 1987 to 1990, commercial lender participation in the GSLP declined by about 29%, with the largest decrease occurring in 1990 (see Exhibit I). The decline of commercial lender GSLP participants (28.6%) exceeded the decline in total U.S. financial institutions (17.75%). Approximately 38% of GSLP lender withdrawal was voluntary as differentiated from those resulting from institutional merger or failure. This circumstance indicates to us that commercial lender support for the GSLP has waned substantially since 1986. We expect further erosion in support even without a change in the Special Allowance.

In support of its case for further reduction of the Special Allowance, the GAO has, based principally on anecdotal information, surmised that "When large-scale lenders discontinue or curtail their [GSLP] participation, it is generally for reasons other than dissatisfaction with student loan profits" (GAO Report, p. 13). This notwithstanding the fact that in the same paragraph the GAO acknowledges that 50% of lenders it surveyed who ceased originating loans did so because of dissatisfaction with student loan profits. We believe that all program participants are motivated by compensation which appropriately rewards risk taking. The other reasons (not enumerated in your report) lenders may have cited, such as program complexity, onerous due diligence requirements, high program administration expense, losses due to default claim rejection, etc., all translate into profitability-related concerns. We suspect more than 90% of lender terminations are caused by compensation insufficient to cover the risks in the GSLP.

In asserting that "The rate of return most commercial lenders receive on Stafford loans is probably higher than the return necessary to retain them in the program" (GAO Report, p. 4), the GAO directly contradicts our experience with the largest lenders in the program. The GAO overstates the real return on the GSL and

understates banks' required return on assets. Heightened concern about bank capital has focused their attention on asset returns. As a rule of thumb, well run banks have after-tax asset returns of about 100 basis points--not the 25 basis points after-tax return contemplated in the proposed cut. GAO also overstates the profitability of GSLP assets when compared to other bank lending and seems to dismiss other factors that have reduced GSLP profitability well beyond the 25 basis point Special Allowance cut in 1986. Specifically, these factors are:

- Introduction of substantial lender risk-sharing, accordingly, a substantial increase in loan losses;
- Increased complexity and costs; and
- A resultant reduction in the student loan's liquidation value in the marketplace.

We strongly believe that 1990 was a turning point in commercial lender perception of GSLP participation. As the higher earnings contributions of loans eligible for the payment of a T-bill + 3.50 special allowance have declined, lenders have become far more aware of the lower net return and more sensitive to increasing servicing costs. Increasingly, commercial lenders have ceased program participation or are adopting short-term GSLP strategies designed to facilitate withdrawal from the program should the value of participation further deteriorate. The most visible of these strategies include:

- Cessation of lending to high cost/high risk segments of the student borrower population.
- Transfer of GSLP origination and servicing functions to a third-party agent to eliminate further investment in GSLP operations.

As has been widely noted by the industry's most experienced observers, the net effects of lender response to declining portfolio profitability over the last 24 months have been:

- The well-publicized diminution of GSLP access for certain proprietary school and community college students.
- A withdrawal of "national" and regional lenders from what are perceived as low-profit state markets.
- Commercial lender refusal to provide funding for guaranty agency-sponsored loan of last resort programs.

- Concentration of high-volume GSLP servicing capability among relatively few contract servicing organizations that currently service 87% of all outstanding GSLP loans.

These effects were concretely evidenced in 1990 when, for the first time since 1986, commercial lenders' GSLP origination volume declined (see Exhibit II). This decline was not addressed in the GAO Report. This 1990 drop in loan volume occurred in a period in which there was no evidence of a corresponding decline in loan demand. In fact, enrollment and education cost statistics suggest an increase in loan demand. This reduction in commercial lender-generated loan volume directly contradicts the GAO's assumption that large lenders who continue GSLP participation will fully absorb unmet loan demand resulting from cessation of lending activity by former GSLP lenders. Moreover, the current existence of localized access problems points up the weakness in the GAO's failure to acknowledge important differences in geographic and school sector-based support among commercial lenders. Failure to acknowledge these differences will inevitably lead to dubious conclusions regarding the potential impact of further reduction in the Special Allowance on loan access.

ASSESSMENT OF THE RELATIVE PROFITABILITY OF GSLP ASSETS

"The financial return on Stafford Loans is high relative to comparable investments." (GAO Report, p.7)

Our examination of the relative net rates of return on various consumer loan products that constitute "comparable investments" to GSLP loans reveals that the GAO's conclusion on this point is simply incorrect. In fact, comparative average 1989/1990 net return data released by the Consumer Bankers Association and the Federal Reserve indicates that the average net return on student loan is substantially below that of other types of consumer loans. Specifically, an analysis of 1989 pre-tax returns on various guaranteed and consumer loan products delivered through commercial lending institutions (see Exhibit III) reveals that:

- The average Guaranteed Student Loan produces a net yield of 89 basis points.
- The average unsecured consumer loan portfolio produces a net yield of 230 basis points--nearly three times that of a GSL portfolio.
- The average portfolio of 100% guaranteed/collateralized SBA loans produces a net return of 267 basis points--three times that of a GSL portfolio.

- The average credit card portfolio produces a net return of 328 basis points--nearly four times that of a GSL portfolio.

Each of the returns set forth above is net of credit losses to be comparable to GSL returns.

The above consumer loan return information is in marked contrast to the assertion made by the GAO. Since there is no source data referenced by GAO, we are not able to square their observations with the industry-provided statistics. Not surprisingly, we conclude from the above comparisons that the more than 50% cut in net earnings inherent in the GAO's recommended Special Allowance reduction would precipitate broad-based reevaluation of GSLP participation among large, mid-size and small commercial lenders. At a minimum, one could expect banks to focus their support on the least costly segment of the student loan market.

ASSESSMENT OF GUARANTY AGENCY CAPABILITY TO ASSURE ACCESS

"Guaranty agencies would continue to assure access." (GAO Report, p. 10)

Based on its assertion that "Guaranty agencies can readily fill the gap between student loan demand and commercial loan supply" (GAO Report, p. 10), it appears that the GAO views the guaranty agency community as a ready and able "access assurance fall-back" if lender participation were to decline to or beyond the level forecast by the GAO as a consequence of a second cut in Special Allowance. We find no evidence in the report or elsewhere to support this view and, conversely, find considerable evidence to support the view that guaranty agencies cannot be counted on to serve as "safety nets" for borrowers displaced from the program. This view is supported by the following observations:

- A large number of guaranty agencies are not legally empowered under their existing charters to engage in direct lending activity. Those that are so empowered are generally limited to making loans to either residents of or students attending schools in their designated state of operation.

- Many guaranty agencies currently do not have the operational ability to implement and administer direct lending programs. They cannot be expected to be uniformly responsive to satisfying unmet loan demand in their states via a direct loan program. As a group they lack the efficiencies to originate loans within the cost limits

imposed under a reduced Special Allowance payment structure.

- Three quarters of all 1989 direct lending volume produced by guaranty agencies was generated by three guaranty agencies and guaranty agency-affiliated direct loan agencies. Nearly half of that lending represented non-subsidized guaranteed loans to students from middle to high income families who did not otherwise qualify for need-based Stafford loans, and whose loans are the least costly to administer. This type of lending activity is far from the global capability envisioned by the GAO.

Guaranty agencies and guarantor-affiliated direct loan agencies will encounter the same return related problems as commercial lenders under the reduced GSLP earnings rate scenario proposed by the GAO. Under last resort loan programs, it is likely that returns would be even narrower for guaranty agencies than for commercial lenders. Specifically, state agency lenders principally will make loans to students who cannot obtain them from commercial lenders who view them as "high cost" borrowers. Student loans to high default borrowers represent a net cost to lenders not a net return. Accordingly, rather than being the answer, guarantors could be put in a position of depleting their already thin capital levels.

Another key issue that the GAO has not addressed in its discussion of guaranty agency-administered direct loan programs is the question of how guaranty agencies would fund potentially high volume direct lending activity. Most guaranty agencies do not have the financial wherewithal to fund such programs. In fact, numerous agencies are struggling to maintain solvency as a consequence of the "Spend Down" of agency reserves earlier mandated by law as a revenue enhancing measure. Those agencies that could reasonably access the U.S. capital market would likely pursue tax-exempt financing which would both: 1) be limited by the agency's allocation of tax-exempt funding authority under its state's tax-exempt financing cap; and 2) to the extent successful, have the effect of eroding Federal savings associated with a reduction in Special Allowance payments.

Finally, we suggest that the fact that very few guaranty agencies have actually implemented agency-funded loan of last resort programs casts serious doubt on the GAO's apparent assumption that such programs can or will be implemented simply by Federal fiat. The last resort obligations of guaranty agencies were not imposed by law as a means for the general substitution of guaranty agencies for unwilling financial institutions. Rather, it was to provide a safety net for particular locales evidencing access problems. Picking up the pieces left by a generalized defection of program lenders is not

contemplated in the law and would, no doubt, be resisted by guaranty agencies.

CONCLUSION

The data and observations presented in this response to the GAO's report on, and recommendation for, a 50 basis point reduction in Special Allowance payments suggests that such action could be expected to have a significant adverse impact on future private sector support for the GSLP and, derivatively, on student and parent access to GSLP loans. In the light of the realities of the environment in which the GSL program operates today, it verges on recklessness to suggest severely cutting an already marginal return on the grounds that an earlier cut did not produce such dire program consequences.

While we recognize the Federal government's desire to reduce the costs of GSLP administration, we think the GSLP is at the point where commercial lender GSLP participants cannot be expected to withstand further reduction in Special Allowance and where viable replacements for those lenders will simply not materialize.

Sincerely,

Albert L. Lord
Executive Vice President and
Chief Operating Officer

Enclosures

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